October 9, 2009
Macro Economics·Monthly Report

Global Monthly. Issue of October

No QE exit before 3Q10

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Overview

The world leaders of countries participating in the Pittsburg G20 summit have confirmed that the global recovery is gaining pace. As growth remains fragile, they decided to maintain their effort via the continuation of stimulus plans. Beside this and the reform of financial regulations, they underlined the necessity to prepare exit strategies from historically expansionary policies.

Focus: No QE exit before 3Q10

The Board of the Reserve Bank of Australia recently decided to raise its official rate (cash rate) from 3% to 3.25% on October 6, 2009. This decision represents the first tightening movement of monetary policy among the big Western central banks. Will the Fed, ECB and BOE follow the movement? Is it time now to come out of the quantitative easing (QE) policy?

The Fed's exit strategy, like the ECB and the BOE, will firstly consider reducing its special lending programs, which provide liquidity to the banking sector. In that sense, exits strategies have already begun as the central banks progressively close these liquidity-programs with the reduction of pressures on the money market. Nevertheless, even if these unconventional tools have been effective in stabilizing the banking sector, their results in supporting the housing market and the general level of activity are less effective. That is why the central banks maintain their securities purchase programs and continue to increase the size of their assets.

We consider that exit of QE will really take place once the central banks' asset size begins to decrease. The real decrease in assets can only be done via conventional tools including increase in official rates. That is why macroeconomic conditions will be the main factors in determining the timing of the QE real exit. The economies of these countries will have to withstand such an increase in short term interest rates. As a result, the "real" exit of QE is not likely to take place before 3Q10.

Indeed, Australia is not the representative of the rest of Western economies. In these countries, inflation remains far below the official target, GDP is far from reaching its potential, and the unemployment rate will continue to increase. Given still fragile fundamentals, the monetary authorities of the US, EU and UK are likely to maintain the QE via the outright purchase of securities, and keep their official rate at 0.25%, 1% and 0.5% respectively until 3Q10.